

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Real Estate- Review of Policy and Procedure
for Commingled Funds

ITEM NUMBER: 11

ATTACHMENT(S): 2

ACTION: _____

DATE OF MEETING: May 3, 2000

INFORMATION: X

PRESENTER(S): Patrick Mitchell

EXECUTIVE SUMMARY

At the April 5, 2000 Investment Committee meeting, staff was directed to provide the real estate policy and procedure for commingled funds for review at the May Investment Committee meeting. The real estate policy has been included as Attachment 1. The commingled fund procedures have been included as Attachment 2.

Staff and Pension Consulting Alliance will be available for questions, if necessary.

CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

REAL ESTATE *Policies*

INVESTMENT BRANCH
SEPTEMBER, 1999

California State Teachers' Retirement System
Real Estate
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INTRODUCTION

In accordance with the Investment Management Plan, the California State Teachers' Retirement System (CalSTRS) has established an allocation for investment real estate, an illiquid equity related asset, using internal staff and external specialized professionals. The primary objective for investment real estate is to improve diversification of the overall investment portfolio. The investment real estate portfolio will also have secondary objectives to achieve a rate of return which corresponds to the amount of risk outlined in the real estate portfolio risk/return composite approved by the Investment Committee and to provide a stable cash flow to the investment portfolio.

Investment real estate can be divided into three broad categories of risk: (1) low risk, (2) moderate risk, and (3) high risk. Each risk category contains certain characteristics which have been included as Exhibit 1. CalSTRS investment real estate portfolio will have a strategic target risk/return allocation of 50% low risk, 25% moderate risk and 25% high risk.

CalSTRS investment real estate portfolio may consist of real estate assets purchased and owned by three main investment ownership structures: (1) direct investments, (2) commingled funds, and (3) securitized investments.

The CalSTRS Board has established the asset allocation and strategic objectives for the real estate portfolio. The purchase, management and sale of all types of real estate investments are performed by external professionals who are monitored and evaluated by internal investment officers and an external real estate consultant. The internal investment officers operate under the direction of the Chief Investment Officer or designee. The external real estate consultant reports directly to the CalSTRS Board.

This manual will establish the policies involved in the management of investment real estate. The policies are designed to set boundaries for expected performance, diversification, and investment structure. A flow chart is provided to establish context for the policies presented.

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The following represent approved policies to be utilized in the management of the California State Teachers Retirement Systems (CalSTRS) investment real estate portfolio. The policies are designed to set boundaries for the expected performance, diversification and investment structure. Policies approved by the CalSTRS Board cannot be altered without explicit direction from the CalSTRS Board.

1. **Laws and Statutes** - The investment real estate portfolio of the California State Teachers' Retirement System is to be invested, managed and sold in a prudent manner for the sole benefit of CalSTRS participants and beneficiaries in accordance with the Teachers' Retirement law and other applicable statutes. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, will be authorized for the investment real estate portfolio.
2. **Role of Investment Real Estate** - The primary role of the investment real estate portfolio is to provide improved diversification to the overall investment portfolio. Secondary objectives are to generate an enhanced yield to the actuarial rate assumption and to provide stable cash flows.
3. **Portfolio Risk Composite** - CalSTRS has established a composite risk range for the investment real estate portfolio. A strategic allocation target of 50% in low risk and a range of 40% to 75%, a 25% target for moderate risk with a range of 10% to 25% and a target of 25% for high risk with a range of 10% to 25% will be used. The definition of the different risk levels has been included as Exhibit 1.
4. **Portfolio Leverage** – CalSTRS may utilize leverage for directly owned, including joint ventures, moderate and high-risk real estate assets to enhance investment returns. Consideration will be given to the risk associated with such leverage on the overall real estate portfolio with specific limitations identified in Exhibit 1.
5. **Portfolio Cash Flow** - The projected cash flow for new acquisitions in the low risk portion of the investment real estate portfolio is expected to approximate the actuarial rate assumption over a five-year horizon. Moderate risk and high-risk investments will not be constrained by cash flow targets and will emphasize yield enhancement over a shorter time frame than low risk investments. Exceptions to this policy will be approved, in writing, by the Chief Investment Officer.
6. **Property Type** - The property types used for direct investments in the real estate portfolio are defined as Industrial, Land, Multi-Family Residential, Natural Resources, Office, Retail, Single Family Residential, and other property types as approved in writing by the Chief Investment Officer.
7. **Geographic Location** - Geographic regions for investing are defined as the location of the individual property. The geographic breakdown is expressed as Mid-West, East, South, West, and International. Properties located outside the United States can be held only in the high-risk category.

8. Investment Ownership Structure - CalSTRS can invest and hold real estate assets in the following three investment ownership structures: (1) direct investments, (2) commingled funds, and (3) securitized investments.

9. Diversification Guidelines - The direct low risk investments contained in the investment real estate portfolio shall have a strategic target and range established for the following diversification criteria: (1) property type and (2) geographic location. The target and range for each criterion are included as Exhibit 2. Purchases or sales shall not be completed for the sole purpose of aligning one specific criterion. Projected rate of return, composite risk profile, and other policies should receive consideration in all transactions. Moderate and high-risk investments will not have diversification targets by property type or geographical location.

10. Investment Limitations - Graduated limitations of daily buying and selling cash, securities, and properties for aggregate real estate equity investment portfolio transactions are as follows (including lock box transactions):

Associate Investment Officer	\$ 5 million
Investment Officer I	\$ 10 million
Investment Officer II	\$ 25 million
Investment Officer III	\$ 50 million
Director of Real Estate	\$ 250 million
Chief Investment Officer	\$ 1 billion

11. Discretionary Authority - The rejection and approval decision for low, moderate and high risk direct ownership properties, co-investments, commingled funds and secondary interests is delegated to Staff with the stipulation that all investments are subject to the appropriate due diligence as defined in the real estate procedures.

The approval of major capital decisions including the decision to acquire, finance, refinance, renovate, expand, or sell is delegated to Staff considering the following stipulations:

- A. Due diligence process shall be consistent and appropriate as defined in the investment real estate procedures.
- B. Maximum amount of the commitment should not exceed \$100 million.
- C. A final recommendation report will be presented to the Investment Committee as soon as practical after the transaction is completed.
- D. Direct real estate assets and commingled fund strategies located in the United States.

Staff can delegate the above authority to CalSTRS' real estate managers for the implementation of the low risk investment strategies.

12. Authorized Signers - Authorization letters which indicate who may sign on behalf of CalSTRS shall be delivered to the appropriate parties. Whenever a change in authorized signers(s) occurs, the effected parties shall be notified within 24 hours in the event of termination and as soon as possible in the event of a newly authorized signer.

- 13. Policy Reporting** - CalSTRS' real estate consultant shall monitor the investment policies and report to the CalSTRS Board as requested.
- 14. Performance Benchmark** - CalSTRS' shall use the NCREIF Property Index to benchmark real estate investments in the portfolio.
- 15. Annual Business Plan** - The Real Estate portfolio will be managed according to an annual business plan whose main business components will encompass an analysis of the investment environment, a review of the investment strategy, a review of the diversification targets, and a resource allocation budget.
- 16. Portfolio Reporting** - The real estate consultant will prepare and present a portfolio management report on a semi-annual basis. The management report will evaluate CalSTRS' property and regional diversification and property and partnership performance.

Adopted on September 1, 1999

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Definition of Risk Characteristics

Investment real estate can be categorized into a risk and return spectrum comprised of low risk, moderate risk, and high risk. The following table reflects the characteristics of the three categories of risk:

Low Risk

- Expected real rate of return of up to 6% (after inflation)
- Traditional property types (industrial, office, retail and apartments)
- Substantially leased at acquisition (higher than 90% leased)
- No leverage on the property
- Cash flow from property is the largest component of return
- Properties located in large and diverse geographic areas in the U.S.

Moderate Risk

- Expected real rates of return between 6% to 12% (after inflation)
- Traditional and non-traditional property types. Non-traditional property types may include, but are not limited to, timber, hotels, senior housing and mini-storage.
- Partially leased at acquisition (higher than 50%)
- Moderate leverage (up to 50% loan to value)
- May be vacant or construction related (i.e. new development and redevelopment) if the leasing requirement stated above is in place at funding.
- Cash flow and appreciation are both large components of future value
- Geographically concentrated within the U.S.

High Risk

- Expected real rate of return higher than 12% (after inflation)
- Traditional and non-traditional property types. Non-traditional property types may include, but are not limited to, timber, hotels, senior housing and mini-storage.
- May be vacant or construction related (includes new development and redevelopment)
- Moderate to high leverage (between 50% to 90% loan to value)
- Appreciation is the largest component of future value
- Geographically concentrated; potentially international locations

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Diversification Criteria for the Direct Portfolio

Geographical Location	Range	Target	8/31/99 Actual
• West	30% - 50%	40%	50%
• South	15% - 35%	25%	18%
• East	10% - 30%	20%	24%
• Mid-West	5% - 25%	15%	8%
• International	0% - 10%	0%	0%

Property Type	Range	Target	8/31/99 Actual
• Industrial	15% - 35%	25%	26%
• Apartments	10% - 30%	20%	15%
• Office	30% - 50%	35%	43%
• Retail	15% - 35%	20%	16%
• Other *	0% - 10%	0%	0%

* Other to include Land, Single Family Residential, Natural Resources and Hotels

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Business Plan**

GLOSSARY

ADVISOR – A company which, by contractual agreement, provides property investment opportunities and/or property asset management services.

APPRAISAL – An estimate or opinion of market value.

APPRECIATION – The percentage change in the market value of a property or portfolio over the period of analysis.

ASSET MANAGEMENT – The various disciplines involved with managing real property assets from the time of investment through the time of disposition. Proper asset management plans and policies include requirements for operating and capital budgets; property management; leasing; physical property analysis; operational and financial reporting; appraisal; audits; accounting policies; and asset disposition plans (hold/sell analyses).

BENCHMARK – An index derived from database information which allows for comparative performance evaluation within an asset class.

CAPITAL IMPROVEMENTS – Expenditures that cure or arrest deterioration of property or add new improvements to prolong its life.

CO-INVESTMENT – Investments where the management organization has a capital investment and ownership share.

COMMINGLED FUND – A term applied to all open-end and closed-end pooled investment vehicles designed for institutional tax-exempt investors. A commingled fund may be organized as a group trust, partnership, corporation, insurance company separate account, private real estate investment trust or other multiple ownership entity.

- **Open-end Fund** – A commingled fund with no finite life, that allows continuous entry and exit of investors, and typically engages in ongoing investment purchases and sale activities.
- **Closed-end Fund** – A commingled fund with a stated termination date, with few or no additional investors after the initial formation of the fund. Closed-end funds typically purchase a portfolio of properties to hold for the duration of the fund and, as sales occur, typically do not reinvest the sales proceeds.

DISCRETION – The level of authority given to an advisor over the investment and management of a client's capital once that capital is allocated to the advisor.

DIRECT INVESTMENT – An investment in which CalSTRS has a direct ownership interest in a property or group of properties.

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FAIR MARKET VALUE – The highest price a property would bring if exposed for sale in the open market by a willing seller to a willing buyer with both parties being fully informed of all the uses and purposes to which the property is reasonably adaptable and available.

GROUND LEASE – A lease of land only, not including any improvements on the property.

INCOME – The component of return derived from property or portfolio operations during the period of analysis.

INTERNAL RATE OF RETURN (IRR) – The actual (or projected) dollar-weighted holding period return produced by an asset, calculated with consideration for all items of cash in and cash out.

JOINT VENTURE – An investment structure wherein differing and often disproportionate ownership interests are acquired by the individual venture partners.

LIMITED PARTNERSHIP – A partnership with both general and limited partners in which the general partner manages the business and assumes full liability for the partnership obligations with the liability of the limited partners generally restricted to their capital contributions.

NCREIF INDEX – National Council of Real Estate Investment Fiduciaries Index; a property-level performance benchmark for institutionally owned real estate, calculated on a quarterly basis.

NET OPERATING INCOME – Rental and other income of a property, less operating expenses but before the deduction of capital expenditures and debt service.

OPPORTUNISTIC – A phrase characterizing investment in underperforming and/or undermanaged assets typically purchased from distressed sellers; utilizing high levels of leverage with the expectation of near-term increases in cash flow and value.

PROPERTY MANAGEMENT – The various functions that are performed at the property level in order to assure timely collection of rents, payment of expenses and supervision of on-site activities.

REAL RATE OF RETURN – Yield to the investor after adjusting for inflation (typically determined by the Consumer Price Index).

TOTAL RETURN – The sum of the income and appreciation returns.

VALUE-ADDED – A phrase commonly used by advisors to describe a management approach to a property with the connotation that their skills will add value which otherwise would not be realized.

INVESTMENT REAL ESTATE PORTFOLIO PROCEDURES COMMINGLED FUNDS

The Board adopted the Investment Management Plan, which was originally drafted in 1986, and has been periodically updated to reflect the changes that have occurred in the investment strategy and policy. The Investment Management Plan mandates the investment of plan assets in four broad categories: public equity, public debt, private equity, and private debt. The following reflects procedures for investment real estate, part of private equity:

Delegated Roles and Authority

1. **CalSTRS' Board** -- Establishes the role of the investment real estate program and approves the asset allocation target, range and risk profile of the investment real estate program. Directs the Chief Investment Officer (CIO) and Real Estate Consultant to periodically report on the compliance with established policies and procedures.
2. **Chief Investment Officer** -- Establishes the program guidelines in such areas as (1) evaluating commingled funds, (2) declining or approving of commingled funds (within the amounts delegated by the Board), and (3) establishing targets and ranges for diversification purposes.
3. **Real Estate Consultant** -- Reports directly to the Investment Committee on matters of policy. Monitors the performance of the real estate portfolio and compliance with approved policy.

Acquisitions/Commitments

1. **Investment Officer** -- The investment real estate unit receives and reviews offering memoranda from a variety of sources. The offering memorandum provides an overview of the investment philosophy, strategy, and terms and conditions of the proposed commingled fund. The investment officer(s) review and analyze the principal terms and conditions of the proposed fund and major accomplishments of the management group.
2. **Investment Officer** -- After analyzing the offering memoranda, if there is sufficient interest and compatibility, the investment officer may arrange a meeting with the commingled fund.

Subsequent to this meeting, the investment officer(s) will evaluate the merits of the proposed commingled fund investment strategy, terms and conditions, management's qualifications, and previous track record. A ranking is assigned between one to ten, with one being the lowest and ten the highest.

3. **Director of Real Estate** -- The investment officer(s) will discuss the proposed commingled fund with the Director of Real Estate. After discussion, the Director of Real Estate may present the qualifications of the proposed fund to the Chief Investment Officer. A detailed due diligence process will be initiated unless the Chief Investment Officer disagrees. To facilitate the due diligence process an independent fiduciary or CalSTRS' real estate consultant may be utilized as an advisor. Written documentation of the due diligence process is important and to be included in the material for future reference.
4. **Investment Officer and/or Independent Fiduciary (IF)** -- Under the supervision of the Director of Real Estate, the staff and/or IF may be asked to conduct due diligence in accordance with but not limited to the following aspects:
 - A. Experience working together as a team
 - B. Identifiable track record
 - C. Special skills or industry expertise
 - D. Size of proposed fund in comparison to previous experience
 - E. Well defined and realistic investment strategies
 - F. Ability to realize profits with successful exit strategies
 - G. Ability to add value through revitalization's or acquisitions
5. **CalSTRS Board or Chief Investment Officer** -- After completion of the due diligence process, the commingled fund commitment will be approved or declined within delegation amounts listed in sections 9 and 10 of the policy section.
6. **Investment Officer** -- After approval of a commitment to an investment, CalSTRS will analyze the terms and conditions of the commingled fund. Any terms which are identified as potentially unfavorable or inconsistent with CalSTRS' goals and objectives are then discussed and negotiated with the commingled fund. CalSTRS may decline participation in an investment if terms considered to be "deal breakers" cannot be resolved in a satisfactory manner.
7. **Investment Officer and CalSTRS Legal Counsel** -- While negotiating terms and conditions of the legal commingled fund agreement documents, CalSTRS' legal counsel will be appraised of the negotiation progress periodically. When the documents are acceptable to the interested parties, the consultant and CalSTRS' legal counsel will issue their respective written approvals. If any of the terms are identified as unacceptable or objectionable, then CalSTRS or the consultant will enter into additional negotiations with the commingled fund. When all terms have been finalized and approved by all parties, the documents are forwarded to the Chief Investment Officer for review and signature.

Management and Operations

1. **Investment Officer** -- CalSTRS' commingled fund investments periodically request cash contributions (capital call). The investment officer receives notice of a capital call on the Fund's letterhead and signed by one or more managing partners. Capital call notice include details on the amount of cash requested, date of transfer, purpose of call, and wiring instructions.

The capital call notices are closely scrutinized by the Investment Officers. The notices are inspected to make certain they include the appropriate signatures and contain all of the information necessary to effect the wire transfer. Any discrepancies identified must be satisfactorily explained prior to processing each capital call notice.

2. **Investment Officer** -- After confirmation of the capital call's amount due, date of transfer, and wire instructions. A purchase transaction form is then completed and signed. The purchase transaction form plus a copy of the capital call notice is for-warded to the operations unit for processing. The purpose of the purchase transaction form is two- fold: 1) to notify the Custodian to schedule payment of the capital call, and 2) to notify the Cash Management function in the Operations Unit to consider the contribution in the cash forecast.
3. **Investment Officer** -- CalSTRS receives periodic cash distributions as a result of its participation in the commingled fund. Notices of cash distributions are sent on the partnership letterhead and contain information regarding date of distribution, amount of distribution, and a description of the source of the distribution. The investment officer reviews the distribution notice and prepares a cash distribution form to the Master Custodian. The purpose of the cash distribution form is two-fold: 1) to notify the Custodian to expect receipt of the funds, including proper accounting treatment, and 2) to notify the Cash Management function in the Operations Unit to consider the distribution in the cash forecast.

Portfolio Monitoring

1. **Investment Officer** -- The investment real estate unit will maintain a cash database which should be updated, at least monthly, to reflect all cash contributions and distributions activity for each commingled fund. The investment officer performs a monthly reconciliation with the master custodian to verify that all transactions are accurately recorded. The investment officer analyzes and reconciles all discrepancies.
2. **Investment Officer** -- The investment officer performs a monthly reconciliation with the consultant for all cash flows to verify all transactions are accurately recorded on a monthly basis and capital balances are reconciled with the consultant on a quarterly basis. All discrepancies are discussed and corrected.

3. **Investment Officer** -- The fund performance worksheet shall be completed on a quarterly basis. The data contained in the worksheet provides specific performance measurements including: net gain/loss in funds, total return ratio, distribution return ratio, and annual IRR.
4. **Investment Officer** -- A market pricing report should be completed and forwarded to the master custodian on a quarterly basis. This report contains information that allows the investments made by the commingled fund to be carried at a market valuation rather than strictly at a cost basis.
5. **Investment Officer** -- The commingled fund's performance and portfolio are closely monitored. Part of the monitoring process includes meeting the managing partners annually either in CalSTRS' office, the Fund's office, or at neutral site. These meetings enable the investment officer the opportunity to effectively evaluate performance and investment strategy, and to interact one-on-one with the general partners. Additional reports will be provided as requested by the Chief Investment Officer, CalSTRS Board, or Internal Audit Department.